# Proposal 6: Better Ways to Promote Saving through the Tax System

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*Deficit Reduction (10-year):* $40 billion

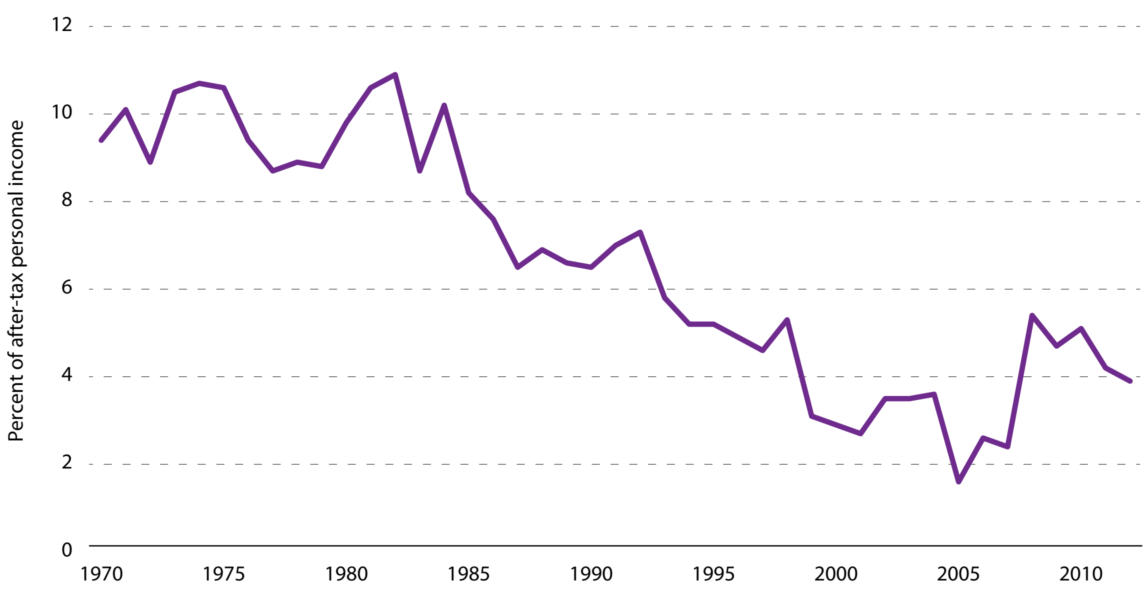
*Broader Benefits:* Improves saving and economic security for low-income households; reduces expensive and ineffective federal subsidies for high-income households.

## Introduction

The U.S. personal saving rate has declined dramatically over the past several decades and is currently very low by historical standards. Americans saved about 4 percent of after-tax personal income in 2012, down from average saving rates of 5.5 percent in the 1990s, 8.6 percent in the 1980s, and 9.6 percent in the 1970s (figure 6-1).

Increasing personal saving in the United States is a desirable policy goal. To be sure, over the near future there would be a downside to households saving more because that means they would be spending less, and, in turn, the economic recovery would not be as strong as it otherwise would be. But, over the longer run, higher personal saving would lead to stronger economic growth. The correlation between a country's saving rate and its investment rate remains large and significant

FIGURE 6-1.
U.S. Personal Saving Rate, 1970–2012




Source: Bureau of Economic Analysis.

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despite the globalization of international capital markets (Obstfeld and Rogoff, 2000). Hence, higher personal saving in the United States should increase investment in this country, which, in turn, should raise our capital stock and our productive capacity.

In addition to promoting higher personal saving in the aggregate, policy also should encourage higher saving among individual households. Households need savings in order to cope with unforeseen disruptions to their income and unanticipated consumption needs. Having such reserves is even more important now than it was in the past because household income volatility has trended upward amid ever-more-competitive and dynamic labor markets: recent research has found that the share of households experiencing a 50 percent plunge in income over a two-year period climbed from about 7 percent in 1971 to 10 percent in 2008 (Dynan, Elmendorf, and Sichel 2012). Moreover, as policymakers look for ways to reduce growing budget deficits, they may cut social programs so that the need for households to have precautionary reserves may be even higher in the future.

Saving also provides households with opportunities. Funds accumulated through saving can be used to pay for college tuition and to purchase big-ticket items such as cars and homes. Saving is likely even more important to attaining homeownership than it was in the past, given the greatly reduced availability of low-down-payment mortgages in the wake of the recent mortgage crisis. In addition, saving puts some households in a better position to establish businesses.

Finally, higher saving is important to households because it means that they will enjoy a better standard of living in retirement. Although most people can expect to receive social security benefits when older and many will receive regular payouts from defined benefit pensions, these sources of income are generally not sufficient to make up for the step down in earnings that occurs at retirement. As a result, many older households will need to supplement pension income with accumulated wealth if they wish to maintain the consumption levels they had when younger. Encouraging adequate retirement savings among lower-income households is particularly important given the available evidence suggesting that these households are much more likely than other households to experience a material drop in their consumption at retirement (Hurst 2008). The possibility of austerity-driven cuts to programs that help older Americans makes the issue even more pressing.

## The Challenge

Many people seem to have trouble saving despite the clear benefits. According to the 2010 Survey of Consumer Finances, only 52 percent of households reported having saved over the preceding year (Bricker et al. 2012). Low- and moderate-income households are the least likely to save adequately, as evidenced by their very low levels of accumulated assets. Among households with heads between the ages of forty-five and fifty-four, the typical household in the lowest quintile of the net worth distribution had financial assets that amounted to less than one week of income and had liquid financial assets that amounted to only a few days' of income. The typical household in the next highest quintile had seven weeks' of income in financial assets and just over one week of income in liquid financial assets. While these latter households are in a better position to weather a temporary disruption to income, the amount of financial assets that they have accumulated could support only a very short period of retirement in the absence of considerable pension income.

Against this backdrop, it is notable that the U.S. government currently puts hundreds of billions of dollars each year into policies that are aimed at promoting higher saving. For example, capital income, such as dividend payments and capital gains, is subject to a lower rate of taxation than is ordinary income such as labor earnings. According to the Joint Committee on Taxation (JCT; 2012a), the lower tax rates for capital income cost the government $93 billion in fiscal year 2012. In addition, the interest on U.S. Savings Bonds is tax deferred, costing the government about $1.5 billion per year. The investment income on saving associated with certain life insurance products is also tax favored at a cost of roughly $30 billion per year.

The U.S. tax code also has features that directly subsidize retirement savings. Employer contributions to defined benefit pension plans on behalf of their employees are not taxed, nor are employee contributions to defined contribution pension plans such as 401(k) programs (both up to some limit). The money in these plans is subject to tax when withdrawn, but, in the meantime, these investments can compound without being taxed each year. Individuals also can set up two types of tax-advantaged deferred retirement accounts, called Individual Retirement Accounts (IRAs), on their own: Traditional IRAs are much like 401(k) plans in that contributions are not taxed until withdrawal. Contributions to Roth IRAs are made on an after-tax basis, but generate investment earnings that compound tax-free until withdrawal. An additional incentive for low- and moderate-income households to save is the Retirement Savings Contribution Credit, commonly known as the Saver's Credit, through which taxpayers with income below certain thresholds may be able to take a tax credit of up to $1,000 ($2,000 if filing jointly) for making eligible contributions to a retirement account. According to the JCT (2012a), the tax spending associated with retirement savings programs amounted to an estimated $136 billion, with the vast majority of the latter sum (more than $120 billion) associated with employer-sponsored defined benefit and defined contribution plans and small amounts going toward IRAs ($12 billion) and the Saver's Credit ($1 billion).

Likewise, our tax code has provisions aimed at encouraging saving for education expenses, although the subsidies associated with these provisions are extremely small. Limited contributions can be made to tax-advantaged Coverdell Education Savings Accounts and 529 Savings Plans. Although the contributions themselves are not deductible from an individual's federal tax liabilities, the principal grows tax-deferred and distributions for the beneficiary's college costs are exempt from tax. The federal tax spending associated with these education saving incentives amounted to just $0.7 billion in fiscal year 2012 (JCT 2012a).

The impact of these various incentives on aggregate and household-level saving is unclear. They all raise the effective return on saving, but the empirical evidence on the general responsiveness of saving to changes in the return is mixed (see Elmendorf 1996). Specific studies of the retirement savings programs also have yielded mixed results. In the most comprehensive study to date, Chetty and colleagues (2012) examine the response to retirement savings incentives in Denmark, which are very similar in structure to those in the United States. They find that most individuals—roughly 85 percent—are so-called passive savers who do not respond to changes in incentives to save, whether from their employer or from the government. The minority of individuals that respond by changing the contributions to their retirement accounts tend to offset these actions with adjustments to their saving in other forms such that there is little impact on their overall savings. With the authors concluding that each dollar of tax spending on these types of subsidies increases total saving by $0.01 (one cent), the study suggests that an enormous amount of tax spending aimed at promoting retirement saving in the United States may be doing little to raise aggregate personal saving.

There are many ways in which the saving incentives currently embedded in our tax system are particularly poorly designed when it comes to the goal of encouraging saving among low- and moderate-income households. The majority of benefits from savings tax preferences go to upper-income households, not only because they simply have more income to potentially save, but also because, on the margin, households in higher tax brackets achieve greater reductions in their tax liabilities for each tax-deductible dollar. At the extreme other end of the income distribution, households with income so low that they have no federal income tax liability receive no benefit at all from the deductibility of their contributions. Indeed, a Tax Policy Center (2009) analysis of the major retirement savings tax expenditures suggested that 84 percent of the benefits went to tax units with cash incomes above $100,000, whereas less than 1 percent went to tax units with cash incomes less than $30,000.

In addition, the very complicated rules associated with some of the tax incentives make it difficult for households who are less financially adept to use them. Research has demonstrated that many households lack basic financial literacy, have difficulty planning, and are prone to making basic financial mistakes (see, e.g., Agarwal et al. 2009; and Lusardi and Mitchell 2007). These limitations likely explain why the rate of take-up on the Saver's Credit is very low (Duflo et al. 2007). One would expect similar logic to apply to accounts, such as IRAs, that individuals have to set up and maintain themselves.

Employer-provided retirement saving programs may mitigate some of these behavioral obstacles to retirement saving, particularly if they have automatic enrollment or default contribution rates. A large literature supports the view that such features do raise saving, particularly for low-income households (see, e.g., Beshears et al. 2012; and Gale, Gruber, and Orszag 2006). Indeed, firms often include these features in order to induce participation by lower-earning employees because IRS nondiscrimination rules limit the share of the benefits that can go to their highly compensated employees. However, only about 55 percent of American workers outside of the military and federal government currently have employers that offer 401(k)s and similar retirement savings plans (Bureau of Labor Statistics 2012).

Low- and moderate-income households may also be reluctant to save through existing retirement programs because they cannot readily access their savings for other uses. Their already low levels of liquid financial assets mean that unanticipated job loss or consumption needs can be particularly disruptive. Although these households have some access to the funds they have saved through retirement accounts, they typically would have to pay a penalty to withdraw the money before age fifty-nine and a half.[1]

To be clear, these arguments do not suggest that eliminating the tax subsidies associated with 401(k)s and similar programs would be a good idea. As noted above, features commonly associated with these programs—such as automatic enrollment and default contribution rates—do tend to raise the savings of low- and moderate-income households. If eliminating the tax subsidies reduced employers' willingness to offer 401(k) programs in the first place, then doing so would run counter to the goal of encouraging saving among low- and moderate-income households.

# The Proposal

A set of reforms to the existing system should make the saving incentives offered through the U.S. tax code more effective at a lower cost. The organizing principle is that tax savings incentives are reduced for higher-income households since such programs appear to be having little effect on the overall saving of this group, with some of the revenue from the reduction in subsidies put toward making saving easier and more attractive for low- and moderate-income households. The reforms are as follows:

- **Cap the rate at which deductions and exclusions related to retirement saving reduce a taxpayer's income tax liability at 28 percent.** Such a change would reduce the benefit associated with contributions to 401(k)s, IRAs, and other qualified retirement accounts for the higher-income tax payers whose tax rate exceeds 28 percent. As discussed above, studies of households' responses to retirement tax incentives suggest that the (mostly high-income) individuals that do alter contributions in response to changes in the return on these investments tend to simply offset these adjustments with changes in other forms of saving. The Tax Policy Center has estimated that entirely eliminating the tax preference for new contributions to defined contribution plans would raise about $30 billion from households in the top 5 percent of the income distribution, which is very roughly the fraction of households that would be affected by a deduction rollback. Limiting the value of the deduction to 28 percent would reduce its value to taxpayers in the 33 to 39.6 percent tax brackets by roughly one quarter. So, if we estimate that the rollback would raise about 25 percent as much revenue as completely eliminating it, the proposal should raise about one quarter of $30 billion, or $7.5 billion per year.

- **Take steps to ensure that more workers are covered by some type of retirement saving plan.** Simply providing more workers with access to a retirement saving vehicle should make it easier and more convenient for them to save. To do so, we need legislation that will:

    - Increase the tax credit that small businesses can take for startup pension plan expenses. Small businesses are much less likely than large businesses to offer retirement savings plans to their employees, presumably because the costs of creating and administering such plans tend to be much higher per employee in small businesses.[2] Small businesses can currently claim a tax credit of 50 percent of startup costs, up to $500 per year, for three years.

    - Establish an automatic IRA program. A second, and complementary, way to ensure that more workers are covered by some type of retirement saving plan is to require employers that do not sponsor a qualified retirement plan to offer automatic-enrollment payroll deductions that put 3 percent of an employee's compensation into a Roth IRA. Very small and newly established firms would be exempt. Although employees would be permitted to opt out of such deductions, the available evidence from studies of 401(k)-type programs with automatic enrollment suggests that many would stay with the program and, in turn, increase their saving. The costs to the firm of setting up a program could be defrayed through a temporary business tax credit.

  The cost of a similar proposal that included doubling the small employer pension startup tax credit (to $1,000 per year) and introducing somewhat smaller startup tax credits for small employers that begin to offer an automatic IRA arrangement was estimated by the JCT (2012b) to cost $300 million in 2015, with the cost rising to about $600 million in 2022.

- **Make the Saver's Credit refundable and easier to understand.** As noted earlier, many households with very low incomes do not benefit from the Saver's Credit because they have no federal income tax liability against which to apply the credit. Making the credit fully refundable so that taxpayers receive the value of the credit even if it results in a net refund from the government, would greatly increase the payoff to making contributions to qualified retirement plans for these households. A second critical reform is for the rules associated with the Saver's Credit to be simplified. Gale, John, and Smith (2012) propose replacing the current system, which features a credit rate that declines as income rises, with a flat refundable credit that is deposited directly into a retirement saving account. Importantly, this framework could be presented as being much like a 401(k)-type plan with employer matches and thus would seem familiar to many households. Given evidence that low-income households do respond to matching incentives when they are easy to understand (Duflo et al. 2006), such a change should spur new saving by this group. A proposal providing a flat 50 percent credit while reducing the maximum credit from $2,000 to $500 was projected to cost the government around $3 billion per year (see JCT 2010).

- **Remove obstacles to firms establishing expanded savings platforms that would allow employees to save for both retirement and nonretirement purposes.** As noted above, lower-income households may be reluctant to lock away their savings in accounts that they cannot readily access for emergency purposes or other needs like college expenses. John (2012) proposes that firms offer their employees

TABLE 6-1.

## Impact of Retirement Saving Reforms on Federal Deficit

| Reform | Approximate change in federal deficit |
|---|---|
| Cap retirement savings–related deductions at 28% | –$7.5 billion |
| Ensure that more workers are covered by some type of retirement saving plan by increasing the small employer pension startup tax credit and establishing an automatic IRA program | $0.3–$0.6 billion* |
| Reform the Saver's Credit | $3.0 billion |
| Remove obstacles to expanded savings platforms | Negligible |

* Lower end represents first-year cost; cost expected to double over the next ten years as take-up rises.

access to nonretirement savings accounts through the same system as the one they are using for their retirement savings accounts. These accounts would offer more-flexible saving options to employees through a familiar framework; features like defaults and automatic enrollment could be used to further encourage participation. The nonretirement accounts would not be tax-advantaged nor would they be subject to the associated regulatory requirements such as Employee Retirement Income Security Act (ERISA) rules. These expanded savings platforms are growing in popularity in the United Kingdom, with the experience there suggesting that competitive forces alone should provide sufficient incentive for the financial firms that manage employer-sponsored retirement accounts to offer additional products under the same platform. Thus, the main role for the government would be to clarify the rules and regulations to make it clear that such accounts are acceptable; the cost to the government of this proposal should be very small.

As shown in table 6-1, the reforms, on net, would reduce the federal deficit by about $4 billion. Savings incentives are reduced for households that have a lot of income (and therefore a lot of capacity to save), but the available evidence suggests that these households are, if anything, likely to respond by shifting the composition of their portfolios rather than by saving less overall. Moreover, the reforms should materially raise saving by households at the lower end of the income distribution such that personal saving might even rise in the aggregate. Of course, these reforms alone are only a starting point when it comes to promoting adequate savings by these households, particularly given that so many of them currently hold so few assets. An even more aggressive reduction in the subsidies for higher-income households could leave room to develop other types of programs to promote saving by low- and moderate-income households.

## Conclusion

Although the saving-related reforms suggested here result in a fairly modest reduction in the federal deficit, they are a step in the right direction and could be combined with reforms in other areas to have a more significant effect on the nation's fiscal sustainability and, in turn, on economic growth. Higher saving by less-advantaged households should also be a positive for economic growth, as it would provide these households with more opportunities and greater economic security, resulting in a stronger workforce and more-resilient consumer demand.

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Karen Dynan is vice president, co-director of Economic Studies, and the Robert S. Kerr Senior Fellow at the Brookings Institution. She is an expert on macroeconomic policy and household finance issues. Prior to joining Brookings, Dynan served on the staff of the Federal Reserve Board (Fed) for seventeen years, most recently as a senior adviser. While at the Fed, she played a leadership role in a number of areas, including macroeconomic forecasting, analysis of household and real estate finance conditions, and the policy response to the financial crisis. She served as a senior economist at the White House Council of Economic Advisers from 2003 to 2004. Dynan's research focuses on consumer spending and saving decisions, household credit use, household financial security, foreclosure prevention, and the effects of financial innovation on economic dynamics. Her papers have been published in top economics journals, including the *American Economic Review*, the *Journal of Political Economy*, and the *Journal of Economic Perspectives*. Dynan has published opinion pieces in the *Washington Post* and the *Financial Times*, and has written for policy publications such as Stanford University's *Pathways* and the *Milken Institute Review*.

## Endnotes

1. Some employers allow retirement plan participants to borrow against their balances for hardship reasons, but the rules vary across plans.
2. Dushi, Iams, and Lichtenstein (2011) find that more than 70 percent of employees in firms with one hundred or more workers had access to defined contribution retirement savings plans in 2006, compared with fewer than 40 percent of workers at firms with fewer than one hundred employees.

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# 15 Ways to Rethink the Federal Budget